Regulatory aftermath of banking rescues:

More Europe or business as usual?

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Abstract: This paper analyzes the EU experience with the cross-border banking failures during the crisis and evaluates the post-crisis reform proposals in the light of this experience. It shows that the Commission considered substantive reforms that would shift the cross-border bank resolution regime to the EU level to match the operational presence of pan-European banks. However, the political compromises on the European System of Financial Supervisors in the Council, led the Commission to withdraw from more ambitious proposals in favor of gradual improvements of the pre-crisis status quo. The reformed structures are still too complex to be functional in real-time under the pressure of a financial crisis and they leave too many crucial issues such as sharing of information and of fiscal burdens in the domain of non-binding soft law agreements yet to be prepared by supervisory colleges. The new framework does not change the exclusively national accountability of supervisory authorities, thus the new regime is unlikely to prevent non-cooperative resolution strategies. The first round of post-crisis regulatory reforms brings in more Europe to the cross-border bank resolution regime, but just barely so.

Keywords: reform, financial regulation, European Union

The financial crisis has tested the viability of the EU's single banking market and its underlying regulatory framework under severe market conditions. It has highlighted the regulatory gap between the degree of financial integration manifested in the presence of large cross-border banks, on one hand, and limited regulatory integration exemplified by the country-based bank resolution regimes on the other. Exogenous shocks such as the crisis create an opportunity for reforms that would have been implausible during the preceding period of stability by forcing the stakeholders to reconsider their policy positions in light of the new experience (Rodrik 1996:27, Drazen and Grilli 1993:598). This article asks whether the Commission seized the opportunity created by the crisis experience to propose an integrated EU level resolution regime for the systemically important cross-border banks that dominate the EU banking market.

The analysis of the failure of the pre-crisis regime reveals that national mandates and uncertainty over the distribution of fiscal costs, challenge the commitment of national authorities to multilateral resolution of cross-border banks. This commitment could be strengthened by shifting the decision on the resolution strategy to an EU level authority and an ex post distribution of fiscal costs. The Commission considered such proposals, but lack of acceptable burden-sharing rules and the hostility of the Council towards imposition of any binding obligations on national regulatory authorities, lead it to abandon such proposals in favor of gradual improvements of the pre-crisis regime. The post-crisis reforms of bank resolution regime thus amount to the gradualist 'business-as-usual' as the more Europeanizing reforms were postponed beyond 2014.

The case of Ireland demonstrates the importance of the bank resolution regime, for banks, national economies and the EU. In September 2008, during the period of the highest uncertainty after the collapse of Lehman Brothers, the Irish government issued a blanket guarantee on all deposits in Irish banks. This had led the outflow of deposits from other EU countries — especially the UK — to Ireland, forcing other EU governments to issue similar uncoordinated policies.[1] Subsequently, the guarantee put the solvency of Ireland into question, thus extending the Eurozone turbulences beyond Greece, and leading to the €85 billion joint EU-IMF program for Ireland. This package contained specific measures for recapitalization, downsizing, restructuring and reorganization of Irish banks (Department of Finance 2010). Had there been a credible bank resolution regime, Ireland could start the restructuring already in 2008 and avoid much of the uncertainty and contagion to the rest of Europe.

The Irish case demonstrates that even resolution of primarily national banks may have important cross-border consequences. Such spillovers are assured, however, if any of the 40 or so systemically important cross-border banks that dominate EU economy faced instability in several countries simultaneously. These banks provide a core financial infrastructure for the daily operations of European economies and, in case of their failure, cannot be simply closed down and liquidated. They need to be resolved as 'going concern' so that their elementary functions are preserved in order to minimize the damage to wider economy. This is the objective of the cross-border bank resolution regime, which the EU strives to develop since late 1990s, and which was tested most directly by the failure of Fortis.

The next section defines some basic characteristics of and challenges to the cross-border bank resolution regime. Subsequent section summarize the key features of the pre-crisis regime that was build on voluntary cooperation and ever more complex governance arrangements and illustrate its failure on the case study of Fortis. The second part reviews the post-crisis reform debates and Commission's attempts to put more integrated policy options on the agenda. The conclusion follows.

The cross-border bank resolution regime: commitment to cooperation

The bank resolution regime is a set of legal and administrative rules that authorities employ to support restructuring of an ailing bank. The regime is crucial especially for systemically important financial institutions that provide essential public good functions such as credit provision, processing of payments and monetary transmission. These functions need to be preserved even in case of the bank insolvency in order to avoid wider economic damage (FSB 2010: 1, Commission 2010c:2, Cihak and Nier 2009: 5). Avoiding disruptions often requires injections of public funds to support failing bank, thus an important objective of the regime is to minimize the fiscal costs of bank resolution (FSB 2010, IMF 2010).

When the ailing bank is systematically important in several countries, then the resolution requires cross-border cooperation. During the pre-crisis decade the EU experienced a wave of large mergers, creating 39 cross-border banking groups and around 100 other banks that had large subsidiaries or systemic branches in another member state (Commission 2009:8). Although these represent a small percentage of the total 8,300 EU banks, they control approximately 68% of all EU banking assets. When such an institution faces difficulties in several countries simultaneously, then it cannot be resolved by any single national authority. The EU bank resolution regime has to have a capacity to resolve such banks, which requires: (i) rules that support the communication and cooperation of all national authorities potentially involved in a resolution of any cross-border systemic bank, (ii) governance arrangements that enable decision-making and implementation of the selected resolution strategy in all relevant jurisdictions, and (iii) financing arrangements that provide sufficient fiscal resources in case they are needed.[2]

The presence of large cross-border banks introduced new set of interdependencies among national authorities and created incentives for strategic behavior. National authorities are accountable to domestic stakeholders and therefore liable to follow resolution strategies that minimize domestic impact, regardless of their consequences for other countries. National authorities face strong incentives to shift the resolution costs to other member states as much as possible. The EU bank resolution regime needs to contain these incentives and ensure a credible commitment to cooperation that minimizes the overall resolution costs and distributes them across the participating countries according to some legitimate criteria.

Apart from conflicting incentives of national authorities, the cross-border bank resolution regime has to meet two additional challenges to national commitment to cross-border cooperation: (i) financial instability tends to proliferate with incredible speed and decisions with momentous economic consequences must be made within few hours or days,[3] and (ii) the final costs of the crisis are highly uncertain for considerable period, which tends to last up to several years. Therefore, the resolution regime must enable national authorities to reach decisions very quickly and sustain them over time. There is little room for ad hoc negotiations during the crisis, and ex post negotiations may be difficult due to conflicts over the distribution of losses. The credible commitment to multilateral cooperation requires ex ante agreements that can be adapted to specific circumstances of the crisis and maintained until all transactions are completed.

The gravity of decisions made in the heat of the crisis is demonstrated by the direct fiscal costs of systemic banking failures. Laeven and Valencia (2008:24) estimated that in the last three decades the direct fiscal costs were approximately 13% of annual GDP on average, which is consistent with the EU experience so far. The nineteen EU member governments that introduced guarantees and recapitalizations, put at risk fiscal resources equivalent to

32% of EU-wide GDP, out of which banks used about 40% by mid 2010 (Commission 2010a).

Problems of national accountability, time-pressure and uncertainty over the magnitude and distribution of fiscal costs conspire against the commitment of national authorities to multilateral cooperation. However, the cross-border bank resolution regime can create considerable economic and political benefits that justify the reform effort.

The multilateral resolution is likely to be the most cost-efficient solution of systemic bank failures, because it preserves the benefits of banks' internal integration, while also avoiding the costs and complexities of separating transnational banks into their national parts. Cross-border banks gained considerable efficiencies from integrating their internal functions across national boundaries. They tend to concentrate the key functions such a strategic decision-making, capital management, risk management and auditing at the headquarters, while other activities such as back-office, information technologies, liquidity management or asset and liabilities management also tend to be concentrated on the group-level, although not necessarily in the home-country (van den Siegel 2008, Commission 2009). Unilateral resolution inevitably destroys these benefits of integration.

The resolution framework also impacts the incentives of national supervisory authorities. If they expect multilateral cooperation during the crisis, then they are likely to focus on the financial stability of the whole banking group. However, if they expect unilateral resolution, then they are likely to focus narrowly on the part of the group within their jurisdiction. They will insist on maximizing its capacity to withstand financial shocks, even if that may be at the expense of stability and efficiency of the rest of the group. Authorities may force local subsidiaries to increase the capital and liquidity buffers, even if they could be better utilized on the group level and provided to the subsidiary only when needed (Unicredit 2009). Such national measures undermine the benefits of single market in financial services.

An underestimated dimension of a well designed cross-border resolution regime is its capacity to prevent economic conflicts form escalating into political ones. Given the high fiscal stakes, absence of clear ex ante rules makes such conflicts very likely. This is amply demonstrated by the lasting dispute between Iceland and UK/Netherlands over the repayment of compensations to British and Dutch depositors of failed Icelandic banks (see Danielsson 2010). This drags for over two years and threatens to become an important hurdle on the Icelandic path to EU membership. Moreover, it was preceded by an unusually harsh decision of the British government to impose the freezing order based on the anti-terrorist law on all assets of an Icelandic bank in the UK, which effectively declared the bank bankrupt before the Icelandic authorities could do so (House of Commons 2009). The Fortis case analyzed below also highlights the intergovernmental conflict over the bank resolution, although in this case it was more contained thanks to the long tradition of cooperation among Benelux governments.

In some crisis circumstances a credible bank resolution regime may provide an important policy alternative. One example was the Irish deposit guarantee mentioned above, but bank resolution regime could also prove important in the ongoing Eurozone crisis, which can be regarded both as sovereign debt crisis in some borrower countries or potential banking crisis in some creditor countries. If some sovereign debt restructuring proves unavoidable, then a credible resolution regime for affected banks could be instrumental in avoiding wider economic damage. This example merely demonstrates, that a cross-border resolution regime is an important part of the wider EU economic governance, where the potential solvency issues of major banks and sovereigns cannot be easily separated (IMF 2010:7).

Pre-crisis resolution regime

The Council responded to the cross-border mergers of EU banks in 1999 by commissioning Brouwer reports on financial stability. These argued against binding EU level rules, because the crisis experiences seemed too diverse to fit any single framework.[4] The reports suggested to focus on improvements of communication and informal cooperation among national authorities. This was a strategy followed by the Council, when it adopted a series of non-binding Memoranda of Understanding (MoU) defining the principles of cross-border cooperation. The soft law approach was criticized by the European Parliament (EP 2010:2) as well as many observers who argued for a clear legislative basis for the resolution regime (see, for example, Dermine 2000, Vives 2001, Veron 2007, Walter and Bergheim 2008: 6-7). Some member states such as the UK and Germany also indicated that new arrangements may be necessary, but were in disagreement over their design (Hartmann et al. 2003: 37). Consequently, the Commission feared political defeat and avoided any legislative initiative before the onset of crisis in 2007 (Speyer and Walter 2009:1).

The first MoU, signed in March 2003, defined elementary principles for cross-border cooperation, identified authorities responsible for crisis management and specified the required flows of information. It also dealt with stages of detection and activation of specific supervisory and central banking tools during the financial crisis (ECB 2003, 2005). The second MoU, adopted in May 2005, expanded the information exchange to sharing prospective assessments and called for the development of contingency plans on the national and EU level. Both MoUs explicitly stipulated their non-binding character and contained no specific provisions on burden sharing (ECB 2005).

The Memoranda were tested in a simulation exercise conducted at the ECB in April 2005, in which 76 banking supervisors, central banks and finance ministries from all EU countries participated (Nyberg 2007: 194). It revealed the inadequacy of the framework as the cooperation was not sustained even under the simulated crisis conditions (Pisani-Ferry and Sapir 2010:349). The Council responded by setting up a working group charged with suggesting new arrangements. Nevertheless, at the onset of the financial crisis in August 2007 the two MoUs were all that was in place.

The third generation MoU was signed in June 2008 and strove to address coordination problems among all 114 national authorities potentially involved in a cross-border resolution. National supervisory authorities, ministry of finance and the central bank were expected to form domestic standing groups and agree on a single authority that would act as a national coordinator. All national authorities potentially involved in resolution of the given financial group were expected to institute cross-border stability groups (CBSG) that would develop the MoU's basic principles into voluntary specific cooperation agreements (VSCA) on the basis of a common template. The general template was the closest the EU got to defining ex ante commitments. The MoU without signed VSCAs remained a declaration of intent and the first VSCA appeared only in August 2010.

The implementation of MoUs was supported by EU governance structures designed to support other financial market regulations. These included the Committee of European Banking Supervisors (CEBS) and colleges of supervisors. The CEBS was introduced by the Lamfalussy reform of the comitology procedures aimed at improving the consultation, decision-making and monitoring processes in financial regulation (Quaglia 2008). It had no specific role in bank resolution, but it provided a permanent cooperation platform for national supervisors. Its information sharing capabilities proved useful in handling the cross-border issues as was the Icelandic crisis (EFC 2009:10). Colleges of supervisors are separate from the cross-border stability groups, as they bring together only supervisory authorities. They operate on the basis of non-binding guidelines issued by the CEBS, and were assigned some formal powers in approving the risk models under the Capital Requirements Directive and regarding the consolidated accounting of financial conglomerates. Without bank-specific VSCA the role of colleges in bank resolution remained only informal. Before the crisis colleges existed only for half of the 40 or so largest EU banking groups, including Fortis.

The Fortis experience of unilateral resolution

The Fortis resolution provided the most direct test of the EU cross-border bank resolution regime during the crisis.[5] The Fortis Group had a systemic presence in the three Benelux countries and it was one of the banking groups with the most developed ex ante cooperation arrangements among its supervisors (EFC 2001:9, Van den Spiegel 2008). Nevertheless, when the crisis tested these arrangements, they failed to sustain a multilateral resolution.

Fortis was created by a merger of several Dutch and Belgian banks and insurance companies in 1990. It expanded rapidly and in 2007 participated in the consortia that acquired ABN AMRO in the largest-ever banking takeover. It became one of the major EU financial groups and its balance sheet exceeded the GDP of any of the Benelux countries. Fortis was headquartered in Brussels, and the Belgian financial authority was its home-country supervisor.

Following the turbulences in global financial markets, Fortis Bank — the entity controlling the banking subsidiaries of Fortis in Benelux countries and the retail operations of ABN AMRO — experienced difficulties in financing the 2007 acquisition. This led to a dramatic fall in its share price and several replacements of key banking officers. The situation escalated on Friday 26 September 2008, when bankruptcy rumors led institutional clients to withdraw deposits en masse (Fortis 2008:14). At the time, Fortis could no longer access the interbank market, and was relying on an emergency liquidity assistance provided by the central banks of Belgium and the Netherlands. The subsequent court investigation revealed that Fortis was solvent at the time (Cihak and Nier 2009:23), but public intervention seemed to be the only tool left to stop the run and prevent discontinuity of services (Fortis 2008: 15).

The Benelux governments approached the Fortis Group with an offer of capital increase of €11.2 bn that would partially nationalize Fortis banks. The Netherlands and Luxembourg would invest €4 bn and €2.5 bn in exchange for 49% of shares in Fortis Bank Nederland and Fortis Banque Luxembourg, respectively. The Belgian government was to invest €4.7 bn in exchange for 49% of Fortis Bank, which controlled all three Fortis banks in the Benelux countries. The Dutch government, however, later withdrew from this plan.

Even before it turned out that the plan would not be implemented, it became clear that it would be inadequate. The run on Fortis banks continued and consumed nearly €60 bn of the emergency liquidity from central banks (Fortis 2008:17). On 2 October 2008, the Dutch authorities announced their intention to impose forced administration on Fortis activities in the Netherlands, unless they are allowed to buy all Dutch assets, including financially stable insurance units.[6] The Belgian authorities and Fortis directors eventually agreed to the sale. Luxembourg increased its share in Fortis Banque to 52%, and Belgium acquired the remaining domestic and international banking and insurance activities of Fortis (Cihak and Nier 2009:23). The government takeovers stabilized Fortis and the attention shifted towards consolidation and sales of the assets acquired by respective countries. This phase of the resolution was conducted primarily on national level without cross-border coordination.

Before the critical week the Belgian authorities could have used the 'early intervention tools' to stabilize Fortis by a capital increase, loan or guarantee. Most such interventions in the EU were carried exclusively by home-countries without cross-border cooperation and, inevitably, their benefits spilled over to host-countries. However, in such cases host-country subsidiaries were stable and provided the home-country with some collateral assets limiting potential losses from the intervention. This balanced cross-border costs and benefits while also recognizing that the home-country had a higher responsibility for overseeing the group as a whole. In contrast, Fortis faced a parallel run on all its Benelux subsidiaries, including the ABN AMRO that was not its consolidated part (Fortis 2008:17). The risk of systemic failure was imminent in all three countries and stabilization thus required a joint action of home- and host-countries. The authorities of the Netherlands and Luxembourg recognized this when they offered their support.

Authorities faced the choice between multilateral and unilateral resolution that can be modeled as a prisoners' dilemma game (Figure 1). The multilateral resolution (M, M outcome in Figure 1) was expected by the MoUs. The unilateral resolution (U,U) would require splitting the banking group along national borders so that the national authorities could deal with each part separately. Given that all three governments were initially prepared to offer joint support to Fortis, multilateral resolution seemed to be the most viable option. Yet, the eventual resolution turned out to be unilateral. The answer to the puzzling outcome lies primarily in the failure of the pre-crisis regime to define clear rules and processes that authorities could follow in crisis in order to maintain their commitment to multilateral cooperation. Under pressure of an escalating crisis national authorities chose the unilateral resolution as a way to reduce uncertainty over the distribution of fiscal costs of the intervention.

Figure 1: The prisoner's dilemma in cross-border bank resolution

		Netherlands	
		Multilateral (M)	Unilateral (U)
Belgium	Multilateral (M)	3, 3	1, 4
	Unilateral (U)	4, 1	2, 2*

Note: * Nash equilibrium. The higher the number in cell, the more preferred the outcome for given player. Preferences are expressed in terms of ranking of pay-offs; the highest payoff (4) is the most preferred solution of a given actor. As the purpose is to demonstrate the conflicting incentives faced by national authorities, the presentation of the Fortis case is simplified by focusing on the interaction between the Belgian and Dutch authorities. The Luxembourg authorities seemed prepared to adapt to outcomes of their negotiations.

The Dutch defection from multilateral resolution agreed on 28 September 2008 was indeed justified by the lower expected resolution costs. The Finance Minister argued that '[the Dutch side] had managed to buy the better part of Fortis, leaving the worse one to the Belgians' (Beck et al. 2010: 73). The Fortis directors and Belgian authorities disputed such a view as banking subsidiaries in both countries were equally dependent on emergency credit from central banks (Fortis 2008:17). The Belgian side could refuse to approve the sale, but there was little time to renegotiate the Dutch ultimatum and without a quick solution the banking crisis could escalate out of control. Therefore, they negotiated a price increase from € 9 bn to €16.8 bn, accepted the Dutch buyout and focused on national resolution.

The Fortis resolution was not multilateral, but did it correspond to the unilateral Nash equilibrium (U,U)? There is also a possibility that one government emerged for the crisis better off then the other, corresponding to the (U,M) or (M,U) outcomes. This ultimately depends on whether the Dutch paid a fair price under the circumstances (implies U,U outcome) or overpaid, in which case they implicitly subsidized resolution costs in Belgium (U,M), or underpaid, in which case the implicit subsidy goes in the other direction (M,U). This will become clearer after the authorities dispose of assets acquired in the transaction and estimate the total costs of the Fortis resolution.[7]

Although the Fortis resolution was not multilateral resolution, it stopped the run on Fortis banks and prevented the situation from escalating into a systemic crisis. This success was, however, predicated on several supportive factors that cannot be assumed in other cases. Firstly, the long tradition of cooperation among Benelux authorities was important to maintain a constructive approach after the Dutch decided not to follow through with the initial agreement and threatened to impose forced administration. The Belgian response was pragmatic and refrained from unhelpful retaliation. Instead, it focused on raising the initial offer that the Dutch were prepared to nearly double in order to prevent a collapse of the negotiations. Secondly, the cooperation among the Benelux authorities was not complicated by any of the asymmetries that may arise in other cases. For example, if a small bank from a large home country controls a systemic bank in a small member state, then national authorities may not be equally concerned and prepared for ad hoc intervention. Moreover, unlike Benelux countries certain EU members may not have the fiscal capacity necessary to support the unilateral resolution of a large bank, as happened in Iceland. Thirdly, the costs of the Fortis break-up were limited, because all important parts of the bank operated as subsidiaries rather than branches and ABN AMRO was not integrated into internal structures at all. The cooperative approach of Benelux authorities, sufficient fiscal capacity and limited break-up costs all aided to the relative success of the unilateral Fortis resolution in containing the acute crisis.

Nonetheless, the Fortis case was a failure of the pre-crisis bank resolution regime that, in its consequences, undermined the single banking market. The key lesson for national authorities is that they should not anticipate multilateral cooperation. General principles noted in MoUs, complex — but voluntary — governance arrangements and unspecified burden sharing rules were insufficient for sustaining the commitment to multilateral resolution. It failed both during the pre-crisis simulations and in the case of Fortis. The lesson for national authorities is that in crisis the resolution will be 'every country to itself' thus they should focus primarily on enhancing the capacity of national subsidiaries to withstand shocks, regardless of the group level consequences. Only credible reforms may change this lesson.

Post-crisis reform debates

The weakness of the pre-crisis resolution regime can be explained by the complacency caused by the previous long period of financial stability as well as by the method of European integration. The traditional EU strategy is to start with market integration and integrate the underpinning institutional framework only later. This tends to create political support for regulatory integration as market players recognize the necessity to proceed beyond the harmonized minimum (Sandholtz and Stone Sweet 1998:2). However, this strategy also creates regulatory gaps, when market actors are no longer effectively regulated on national level, but there is not sufficient EU level regulation (Scharpf 1999).

There are two principled ways of closing the gap between transnational banks and national resolution regimes. One possibility is to shift the resolution regime up to the EU level that provides the largest possible jurisdiction matching the operations of large European banking groups. Alternatively, resolution could be shifted back to the national level, which would, however, require the cross-border banks to reorganize as a string of operationally independent national subsidiaries. These options resolve the conflicting incentives of national authorities either by shifting the decisions to the EU level entity, or by reducing the need for cross-border cooperation through re-embedding of banks in national resolution regimes. These two options also delineate the menu of policies, from which the Commission could draw its post-crisis reform proposals.

Return to national resolution regimes

The idea of re-embedding cross-border banks in national resolution regime — dubbed subsidiarization — was voiced by the UK's Financial Services Authority at the onset of the post-crisis debate (FSA 2009). It reflects UK's experience when the government bore full costs of stabilizing interventions into global UK-based banks, but the benefits were spread across many of their cross-border counter-parties. Moreover, the UK was also confronted with the situation when Iceland could afford neither supporting their banks, nor paying the mandatory deposit insurance to UK customers of its banks (Danielsson 2010). The subsidiarization idea also resonated with some host-country authorities who are reluctant to cede ever more powers to home-country authority of the parent bank (Unicredit 2009: 9).

Reembedding cross-border banks in national resolution regime would require their separation into operationally independent national entities so that, in the event of crisis, they could be resolved solely by national authorities without any extensive cross-border cooperation and burden sharing. In legal terms the EU cross-border banks are compatible with subsidiarization as they typically operate as networks of national subsidiaries, not a single entity relying on branches in host-countries. These subsidiaries meet all criteria of banking license, such as having formally independent management and capital base. However, in practice many of the internal processes are centralized thus subsidiarization would force banks devolve more operational independence to subsidiary managers and adapt their internal structures and processes accordingly (Commission 2009).

Predictably, large international banks immediately countered the idea arguing that even if the national subsidiaries were connected only by a brand name, there would still be cross-border spillovers (IIF 2009: 73-82). They also claimed that subsidiarization would undo achievement of the single market in banking, without addressing the lack of internationally coordinated crisis management. This concern was shared by the internal market Commissioner Michel Barnier: "we need to tread carefully, to avoid the banana skin of protectionism and to ensure that domestic politics does not gain the upper hand over European thinking. The first victim of an 'every man for himself' approach will be the internal market." (Speech 10/122, 19 March 2010). The Commission considered subsidiarization, but refuted it as a viable alternative, because it may require modification of the Treaty that could undermine the internal market (Commission 2009:39).

The subsidiarization did not reappear in the later debates or Commission proposals, but some of its technical substance lingers on as the reform proposals on EU level (Commission 2010c) as well as global level (FSB 2010) that all presume compulsory introduction of recovery and resolution plans for all cross-border banks. These may limit the internal integration of some banking groups in order to make them 'resolvable' on national basis, without the need to engage in complex cross-border cooperation (see Avgouleas et al. 2010).

The EU level resolution regime

The key characteristic of the EU level regime is that it breaks the direct link between decision-making on and financing of bank resolution. It shifts the decision on the most appropriate resolution strategy from domestically accountable national authorities to the EU level agency with mandate to minimize overall costs of resolution, regardless of the subsequent burden-sharing across individual EU countries. The centralized decision-making and fungible financing creates the credible commitment to multilateral cooperation, as it removes the distributive conflicts among national authorities (IMF 2010). However, the EU has no fiscal capacity on its own, thus the financing requires some form of fiscal backing from member states, and, consequently, a burden sharing agreement.

There were proposals to create a single European regulatory agency before the crisis, but they were turned down due to the absence of a clear Treaty base (Angeloni 2008:25). Treaty confers a limited financial stability mandate on the Banking Supervision Committee of the ECB, but this can be expanded neither to non-banking financial services nor to non-euro zone countries. Moreover, both Eurozone members and the UK opposed expansion of the ECB role into financial supervision (Posner and Veron 2010: 409), which led the Schoenmaker and Osterloo (2009:17) to argue that the post-crisis reforms can aspire only to gradual process of closer cooperation resembling the institutionalization of the ECB.

However, the IMF challenged the gradualist assumption and argued for more radical reforms that do not shy away from institutional changes (IMF 2010). It made a proposal for introduction of the 28th legal regime for pan-European banks, that would include an EU level resolution regime. The idea is based on the European Banking Charter, inspired by the Societas Europaea company statute (IMF 2010:60, Cihak and Decressin 2007). The large cross-border banks would be given the option to comply with a complete legislative package defined in a single Regulation that would cover all aspects of banking licensing, regulation, supervision and resolution (IMF 2010:55, Commission 2009).[8] The resolution decisions would be taken by the European Resolution Agency with "adequate powers, clear mandates to pursue the common good based on ex-ante agreed common principles and objectives, robust legal and accountability frameworks, and appropriate safeguards" (IMF 2010: 58). Given that banking crises are rare events ERA is envisioned as a shell agency with small staff capable of quick mobilization of trained experts. Alternatively, the European Banking Authority (see below) could act as ERA in case of crisis. The latter option may be easier to implement, but may also compromise the independence of ERA vis-a-vis national supervisors, who are in control of EBA (IMF 2010:58).

The weakness of the EU level proposal, including the IMF one, is financing. They all stress the effect of parallel reforms that aim to increase the capital buffers of the systemically important banks. Indeed, the Basel III is bound to require more capital from larger financial institutions, which is a complete turn from the Basel II that allowed them to reduce their capital base (Lanoo 2011). Further requirements for contingent capital and 'bail-in' requirements on unsecured creditors, will be imposed the Financial Stability Board that prepares the regime for systemically important financial institutions (SIFI) at the request of G20 (FSB 2010). The FSB has also proposed additional surcharge on SIFIs that would pre-finance a bank resolution fund and the Commission had table the proposal for consultation in May 2010 (Commission 2010b).[9] The IMF also argues for the more flexible use of the deposit guarantee schemes that would allow the use of these resources for bank resolution, provided that keeping the bank afloat is less costly than paying out the deposits (IMF 2010:59, Unicredit 2009:19). All these measures cumulatively reduce the likelihood that fiscal financing may be necessary, but they cannot exclude it completely.

The IMF argues for a joint and several liability of all EU member states for all ERA related debt and guarantees. There are several ways to organize such financing, including the use of European Investment Bank (Goodhart and Schoenmaker 2009: 149) or enlarging the EU budget (IMF 2010:63). However, more plausible alternative may arise from institutionalization of the European Financial Stability Mechanism that was created in response to the Greek and Irish debt problems. This scheme is designed to provide emergency lending to countries without access to private financing, but it could pave the way towards joint fiscal guarantees needed for funding resolutions of major cross-border banks. However, any of the EU level funding schemes still presumes that there is an acceptable burden sharing formula.

The 2008 MoUs specified a burden sharing formula based on the expected economic impact of the cross-border bank failure on the member states concerned and the allocation of home and host supervisory responsibilities. The De Laroisiere report (2009) suggested to expand the list of principles that guide the burden sharing by additional criteria such as the deposits of the bank, assets expressed in terms of accounting, market and risk-weighted values, the revenue flows, and the share of payment system flows. The IMF proposal called for fixed ex ante rules on burden sharing, combined with the power of ERA to adjust their distribution to specific circumstances, where the adjustment should be based on a ratio between avoided damage to bank creditors and broader economy on the one hand and net resolution costs incurred by the national authorities on the other. Although all these criteria are plausible, they are often difficult to estimate and thus are not particularly predictable.

The issue of burden-sharing remains an Achilles heal of EU level reform proposals. There is no obvious way to balance the trade off between the predictability derived from fixed ex ante rules and flexibility needed for adaptation to the specific circumstances of the case. The most specific burden sharing model to date does not come from any high level policy proposal, but rather from the Baltic-Nordic Voluntary Specific Cooperation agreement signed by Norway, Sweden, Finland, Estonia, Latvia, Lithuania and Iceland in August 2010. The agreement implements the 2008 MoU cost sharing model based on asset share of the relevant financial groups in a given country and the home-country supervisory responsibilities. It goes a step further by introducing exacerbating and mitigating factors that can increase or decrease a share of the given country, providing that other countries agree to it. The mitigating factors include early alerting and thus create incentives not to ignore potentially destabilizing problems.

Commission initiatives

Following the early signs of the financial crisis the Council outlined the 'roadmap' for financial reforms in October 2007 and March 2008. The Commission prepared revisions of the Capital Requirement Directive, which inter alia required national supervisors to adapt their mandates to 'have regard to financial stability concerns in all Member States concerned' (Consultation document SEC(2008) 2532: 23). The proposal, made public just at the peak of the crisis in October 2008, did not include any more radical shift towards an EU level regime.

As the inadequacies of the pre-crisis framework became obvious, the Commission was emboldened to consider more ambitions reforms. This is observable in the October 2009 Communication on an EU Framework for Cross-border Crisis Management in the Banking Sector (COM(2009) 561/4) and its accompanying Commission staff working document (SEC (2009) 1407) and impact assessment (SEC(2009) 1389). The Commission staff concluded that the EU bank resolution framework would have overall positive effect on all stakeholders (SEC (2009) 1389:40) and that the integrated approach was best suited for the 'branch-like' subsidiaries of EU cross-border banks (SEC(2009) 1407:50). This was also reflected in the consultation questions that asked for comments on desirability of the 28th regime, to which the IMF responded with the most ambitions EU level proposal to date summarized above.

The October 2009 Communication was the high point for the EU level resolution proposals. The negotiations with the Council and European Parliament regarding the European Banking Authority, have revealed the political limits for post-crisis regulatory reforms. The whole initiative nearly collapsed due to relatively marginal provisions on binding arbitration that could allow EBA to impose obligations on national authorities (see below). After this experience the Commission reverted back to the gradualist improvements on the pre-crisis resolution framework. The Communication on EU framework for crisis management in the financial sector from October 2010 (COM(2010) 579) reiterates that the "integrated framework for resolution of cross border entities by a single European body would deliver a rapid, decisive and equitable resolution process for European financial groups, and better reflect the pan EU nature of banking markets". However, it concludes that such a regime is not achievable in the absence of a harmonized insolvency regime and of a Single European Supervisory authority (Commission 2010c:12). Hence, two years after the crisis the reform strategy is back to the pre-crisis mode that dates back to the 1999 Brouwer reports. National authorities are expected to consult and cooperate within resolution colleges (aka cross-border stability groups) that should prepare ex ante resolution plans, but they are free to defect to unilateral action where they consider that necessary for reasons of national financial stability. The Commission plans to reassess the framework in 2014, when expected progress on some of the complementary reforms can make the shift to EU-level regime easier.

Gradual improvements of the pre-crisis regime

Two years after the crisis, the introduction of EBA — the negotiation of which discouraged the Commission form pursuing more ambitious reforms — remains the only improvement on the pre-crisis regime. In February 2009, the de Larosiere group of wise men recommended a creation of the European System of Financial Supervisors (ESFS) charged with coordination and mediation of disagreements among national supervisors, especially in emergency situations.[10] At the core of the ESFS proposal was the transformation of the existing Lamfalussy committees into European Supervisory Authorities, so that the Committee of European Banking Supervisors became European Banking Authority (EBA).

The EBA received independent chairperson, staff, legal status and EU funding and — importantly for the resolution regime — the power of binding arbitration that allows it to impose binding obligations on national authorities in cases: (i) when arbitrating a disagreement among national authorities supervising a cross-border group; (ii) when national authorities implement incorrectly directly applicable EU Regulations; and (iii) in emergency situations declared by the Council of Ministers. The EBA's decision-making body, which comprises its chairperson and heads of national supervisory authorities, can adopt the arbitration decisions by qualified majority (Gros 2009).

Binding obligations decided by the qualified majority could in principle deliver the credible commitment to multilateral resolution. The EBA could intervene into a dispute among national authorities and prevent any one of them from defecting to unilateral resolution. However, such powers proved controversial in the Council. The UK refused to accept any EU level rule that could result in binding fiscal commitments (EurActiv Dec 3, 2009), hence the Council introduced a fiscal clause declaring that EBA's decisions may not in any way impinge on the fiscal sovereignty of member states. The UK has also insisted on additional "triple-lock" safeguards that can suspend EBA's decisions by giving any member state the right to appeal to the Council, where a simple majority of member states can overturn EBA's arbitration decision. Any member state also has the right to appeal to the European Council. The European Parliament opposed safeguards that undermine EBA's ability to resolve disagreements and, after nine months of negotiations, managed to insert a 'safeguard on the safeguard' clause that bans abuse the fiscal veto if it does not have "a significant or material fiscal impact" (EP 2010: 13). The political safeguards undermine the credibility of EBA's arbitration powers for resolutions of systemically important banks that almost always require some fiscal backing. In such cases, the unilateral resolution remains a formally unconstrained option.

Conclusion

The forty or so systemically important financial institutions that dominate EU banking markets cannot be allowed to fail. They provide the fundamental financial infrastructure for EU economies, which needs to be preserved even in cases of their insolvency. Resolution of failing systemic banks, while preserving their public functions and minimizing the fiscal support, is the task of the bank resolution regime. As banks are internally integrated across EU borders, they should also be resolved on the cross-border basis, without splitting them up along national borders as happened to Fortis. However, national authorities face strong incentives to favor domestic interests and shift resolution costs onto other EU countries. When they believe that the part of the cross-border bank in their jurisdiction is financially more sound than parts of the group in other countries, they have every reason to pursue unilateral resolution strategy that minimizes domestic costs, regardless of its adverse consequences on resolution costs in other countries. Committing national authorities to multilateral cooperation and ensuring proportional distribution of its costs is the key challenge for the EU cross-border bank resolution regime.

Figure 2: Policy options compared

BRR components	EU level regime	Pre-crisis regime
Rules of the resolution regime	28th legal regime for cross-border banks that includes European Banking Charter and Regulation on resolution	Soft-law bank-specific agreements based on 2008 MoU (VSCA)
Governance arrangements	European Resolution Agency (ERA) makes binding decisions	Bank-specific cross-border Stability Groups; conflicts mediated by EBA
Fiscal burden sharing	Fungible funding' through ERA and burden-sharing according to ex ante formula	Bank-specific burden sharing agreements based on VSCA

Before the crisis the EU strove to create the commitment through voluntary agreements and ever more complex governance arrangements. However, these failed to support multilateral cooperation not only during the crisis, but even in the pre-crisis simulation exercises. The experience of these failures opened an opportunity to pursue reforms instituting more credible resolution regime on the EU level. Commission proposals from October 2009 praised the potential benefits of an integrated resolution regime, but the constellation in the Council was not favorable, which became clear during the negotiations on EBA. As a result, the Commissioned abandoned the more radical reform ideas by October 2010 and focused fully on the 'business as usual' gradual improvements of the pre-crisis regime (see Figure 2). The more substantive reforms were postponed beyond 2014.

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[1] The Irish decision also indirectly contributed to a bank collapse at the opposite end of EU. When Sweden responded by guaranteeing the deposits in its banks that also control the Baltic markets, the outflow of deposits to Swedish owned banks contributed to a definitive collapse of the already weakened Parex bank in Latvia (Mayes 2009). This only illustrates the interdependencies within the EU financial market.

[2] The cross-border regime also needs to address the fact that different jurisdictions provide different variations of resolution tools such as asset transfers, bridge-banks, assisted sales, nationalizations or interventions financed from deposit insurance. Harmonization of these tools is a subject of a large technical literature (IMF 2010, FSB 2010, IMF 2009, Cihak and Nier 2009, Eisenbeis and Kaufman 2008, Cihak and Decressin 2007) and is not addressed in this article that focuses on the underlying political aspects of cross-border cooperation.

[3] A typical window for bank resolution used to last 60 hours from the time the bank closed on Friday till it reopened on Monday, but with electronic banking crises no longer stop for the weekend.

[4] The first report concluded that "[t]he existing institutional arrangements provide a coherent and flexible basis for safeguarding financial stability in Europe. No institutional changes are deemed necessary" (EFC 2000: 7), while the second one added that "every crisis is unique, in the sense that its immediate causes, the characteristics of the institution(s) involved, the potential for contagion and so on are different, … [therefore] there is no blueprint for crisis management, either at the European or at the national level. For the same reasons, this report will not attempt to lay out such a blueprint." (EFC 2001:5-6).

[5] Dexia was also the case of cross-border resolution, but it was partially owned by public entities so the national authorities could use not only the indirect resolution tools, but also the direct shareholder powers. Moreover, the proportions of shares owned by the institutional investors and public authorities of the three countries involved in Dexia resolution provided a convenient burden sharing formula (BIS 2009:11). The Icelandic banks were not subject to the 2008 MoU as Iceland (EEA member) signed it only in 2010. All other cases of EU bank instabilities were prevented from escalation across borders by home-country interventions.

[6] The Fortis bank, ABN AMBRO and Fortis insurance firms were all organized as nationally incorporated subsidiaries, not branches, thus the EU legislation did not restrict the right of host-country authorities to impose forced administration.

[7] Morgan Stanley, hired by the Fortis Group, valued the Dutch operations at € 22 bn (Fortis 2008: 18). Market participants questioned by the Financial Times speculated that the Dutch bought the Fortis assets at a discount of as much as €10 bn (FT Oct 4, 2008). These estimates would suggest (M,U) outcome, implying that Belgium bears disproportionately higher burden of the resolution.

[8] The non-systematic national banks that can be resolved without cross-border cooperation, would remain in less harmonized national regimes based on a Directive (IMF 2010).

[9] The proposal suggests introducing a network of national funds rather than a single European fund that was deemed politically infeasible (Commission 2010b). This obviously reintroduces the conflicting incentives into the decision-making as national authorities strive to limit the costs to 'their' resolution fund.

[10] The de Larosiere group of wise men was asked by the Commission to recommend a reform blueprint. It explicitly decided against pursuing politically contentious issues such as a single EU resolution body or EU level financing (de Larosiere quoted in Financial Times, 26 February 2009, IMF 2010:7).